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IN THE

Supreme Court of the United States

OCTOBER TERM, 1952.

No. 612

FRANZ GEORG BLOCH,

Plaintiff-Petitioner,

v.

THE UNITED STATES OF AMERICA,

Defendant-Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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IN THE

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No. .....

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Plaintiff-Petitioner,

v.

THE UNITED STATES OF AMERICA,
Defendant-Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, FRANZ GEORG BLOCH, hereby respectfully requests this Honorable Court to issue a writ of certiorari to the United States Court of Appeals for the Second Circuit, to review the decision and judgment of that Court which reversed the decision and order of the United States District Court for the Southern District of New York in this proceeding.

The District Court had granted summary judgment for the petitioner sustaining his claim for refund of federal income taxes paid in the years 1944, 1945 and 1946 totaling $6,100.28.

Opinions Below.

The opinion of the Court of Appeals is reported in 200 Fed. (2d) 63. It held that petitioner, a nonresident alien, was subject to tax on certain payments received from the United States pursuant to an agreement dated April 29, 1935, on the ground that the agreement was a mere license and the payments mere royalties for the "use" of a patent.

The findings of fact and opinion of the District Court are reported in 102 F. Supp. 457. It held that the agreement constituted a sale of the patent and that the payments were proceeds of the sale and therefore not subject to tax.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on November 21, 1952.

The jurisdiction of this Court is invoked under Section 1254(1) of Title 28 of the United States Code and Section 1141(a) of the Internal Revenue Code.

Summary Statement of Matters Involved.

Petitioner was and is a German citizen and a nonresident alien not engaged in trade or business in the United States. In 1932 he entered into a partnership agreement in Czechoslovakia concerning a bimetal thermometer which he had invented. Application for a United States patent was granted in 1934, the petitioner holding the patent as trustee for the partners pursuant to the terms of the partnership agreement. Thereafter the partners entered into the agreement of April 29, 1935 with Weston Electrical Instrument Corporation (herein called "Weston"), a domestic corporation. The payments involved in this case

are petitioner's share of Weston's payments to the partnership during the years 1944, 1945 and 1946 in accordance with the terms of that agreement (R. 116 to 118).

The Agreement of April 29, 1935.*

By the agreement the partners granted to Weston "an exclusive license to make, use, exercise and vend" under the patent throughout the United States, its territories and possessions, for the full term thereof (Par. 2 and Schedule). In return Weston agreed to pay to the partnership an initial payment of $40,000 (Par. 1), plus certain "royalties" measured by the number of units sold or by their selling price (Par. 4).**

The remaining material provisions of the agreement may be summarized as follows. Weston (referred to as "licensee") was to inscribe "Patent No. 1,970,219" on each thermometer manufactured (Par. 6). It was to keep true and particular accounts (Par. 7). It could not question the validity of the patent (Par. 8). The partners (referred to as "licensors") were to pay all renewal fees and do all things necessary to maintain the patent (Par. 9). The partners agreed to supply six machines for manufacturing the thermometers at $300 each, and gave Weston an exclusive license to make, use and vend them (Par. 10).

---

* The following discussion of the agreement will refer to the numbered paragraphs thereof. The agreement appears at pages 48 to 61 of the Record.

** The "royalties" were: (a) 4¢ on each household thermometer; (b) percentages varying between 10% and 6% of the selling price of other types, the percentage being reduced as the payments reached specified totals; (c) excess royalties at 1¢ on household thermometers and 2½% on others limited to $35,000; (d) an annual minimum of $25,000, exclusive of excess royalties (Par. 4). Separate provisions were made with respect to clinical thermometers, the costs of development and manufacture having not yet been ascertained (Par. 5).

Weston was permitted to grant sublicenses on the same terms and conditions as were applicable to it. Weston agreed that, without the consent of the partners, it would not sell or assign the *entire* license to a third party. In the event of such a proposal, the partners were to have the right of "first refusal to *repurchase* the license for themselves" (Par. 11).

The partners were to give to Weston all their know-how (Par. 12). They were to communicate to Weston any improvements or further inventions relating to the patent, and Weston was permitted to make, use, exercise and vend the same without payment of any additional royalty or premium (Par. 13). Weston was to communicate to the partners any such improvements or further inventions to enable the partners to obtain United States patents thereon and Weston was permitted to make, use, exercise and vend the same without payment of any further royalty (Par. 14).

The partners were to take steps to prevent infringement. The decision to commence such proceedings was to be made by mutual agreement and the costs were to be shared equally (Par. 15). If the patent were to be declared invalid, all royalties ceased (Par. 16). The partners were not permitted to make, use, exercise or vend any devices under the patent or any improvements thereon within the territory covered by the agreement (Par. 17).

If any royalties were in arrears for 30 days, or if Weston were to breach any of its covenants, or become insolvent or be dissolved, the partners were permitted to terminate the license (Par. 18). The partners agreed to execute all necessary documents for the proper vesting in Weston of all rights granted (Par. 19). Weston was permitted to cancel the agreement if it decided to discontinue

making instruments protected by the transferred patent rights (Par. 20). It agreed to start manufacturing under the agreement within 6 months after its execution (Par. 21). If during three consecutive years the minimum of $25,000 were to be paid, without actually being due on the basis of sales, the partners were permitted to cancel the agreement (Par. 22).

Payments Involved.

Weston's obligation under its agreement with the partners required that it pay certain sums of which the petitioner's share for the years 1944, 1945 and 1946 amounted to $5,718.02, $6,525.28 and $8,091.21, respectively. Instead, it paid sums from which the petitioner received $4,002.62, $4,567.78 and $5,663.83, respectively, remitting to the Collector of Internal Revenue, Newark, New Jersey, the respective differences as income taxes withheld. The amounts so withheld in respect of petitioner's shares for the years 1944, 1945 and 1946 were $1,715.40, $1,957.50 and $2,427.38, respectively (R. 118).

Petitioner filed claims for refund of the taxes withheld on March 3, 1948, assigning as grounds for such claims that the sums payable to the petitioner under the license agreement constituted payments of the sales price for the United States patent rights covered by the said agreement. The claims were rejected by the Commissioner of Internal Revenue on November 7, 1949, and this action was commenced on June 28, 1950 (R. 132).

Decision of the District Court.

The proceedings in the District Court were held before Honorable Sidney Sugarman. The Court granted sum-

mary judgment for the petitioner on all issues involved herein, saying:

> "The resolution of these motions [cross-motions for summary judgment] depends upon the agreement of April 29, 1935 between Weston and the partners. Was it a sale or a license?
>
> • • • • • •
>
> In 1936 Congress exempted from tax the consideration received for a sale of personal property by a non-resident alien. Revenue Act of 1936, §211, 49 Stat. 1714 (1936) and §143, 49 Stat. 1700-1701 (1936), 35 *Cornell L. Q.* 893.
>
> • • • • • •
>
> The contract at bar being one for a *sale* of the partners' *entire bundle of rights* under the patent, the plaintiff's motion is • • • granted. • • •" (R. 118, 120, 121). (Emphasis added.)

Decision of the Court of Appeals.

The Court of Appeals reversed the District Court's judgment in favor of petitioner and held that the agreement did not constitute a sale of a patent for tax purposes and that the payments in question were "essentially royalties" subject to withholding. The opinion of the Court was rendered by the Honorable Augustus N. Hand. He said that the Court was aware of the fact that decisions of the Courts of Appeal for the Fifth and District of Columbia Circuits and of the Tax Court were to the contrary, and that it respectfully differed with their conclusions (R. 136).

Reasons for Granting the Writ.

I. The decision of the Court below is in conflict with other decisions of the Courts of Appeals and of the Tax Court and with the Treasury Regulations.

The decision of the Court below is contrary to, and in conflict with, the following decisions of four other Courts of Appeals: *Commissioner* v. *Celanese Corporation of America,* 140 Fed. (2d) 339 (C. A. D. C. Cir., 1944); *Hofferbert* v. *Briggs,* 178 Fed. (2d) 743 (C. A. 4th Cir., 1949); *Kavanagh* v. *Evans,* 188 Fed. (2d) 234 (C. A. 6th Cir., 1951); and *Allen* v. *Werner,* 190 Fed. (2d) 840 (C. A. 5th Cir., 1951).

The decision of the Court below is also contrary to numerous decisions of the Tax Court, including *Parke, Davis & Co.* v. *Commissioner,* 31 BTA 427 (1934) (Acquiescence by the Commissioner of Internal Revenue, XIV-1 C. B. 15); *Myers* v. *Commissioner,* 6 T. C. 258 (1946) (Acquiescence 1946-1 C. B. 3. Withdrawn and nonacquiescence as to period subsequent to June 30, 1950, 1950-1 C. B. 9); *Kimble Glass Co.* v. *Commissioner,* 9 T. C. 183 (1947) (Acquiescence 1947-2 C. B. 3); *Dreymann* v. *Commissioner,* 11 T. C. 153 (1948); and *Taylor* v. *Commissioner,* 16 T. C. 376 (1951).

The decision of the Court of Appeals is also contrary to provisions of the Commissioner's Regulations which have been in effect in the same form since 1936, and which have the force and effect of law:

> "* * * The income derived from a sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income. * * * " (Reg. 111, Sec. 29.143-2. Originally Reg. 94, Sec. 143-2.)

The Court below recognized the existence of a conflict, stating:

> "We are aware of the fact that royalties resulting from a transfer of a patent were apparently held to be payments of the purchase price in *Allen* v. *Werner*, 5 Cir., 190 F. 2d 840, and *Commissioner of Int. Rev.* v. *Celanese Corp.*, 78 U. S. App. D. C. 292, 140 F. 2d 339, but we have not acceded to this view in our decisions, discussed above, and we see no sufficient reason for holding that payments of a percentage of future earnings of a patent should be treated as falling outside the scope of §211(a). So far as the decisions of the Courts of Appeal for the Fifth and District of Columbia Circuits and the Tax Court, *Kimble Glass Co.* v. *Commissioner*, 9 T. C. 183; cf. *Myers* v. *Commissioner*, 6 T. C. 258, are to the contrary we respectfully differ with their conclusions."

II. This case raises important questions of federal law which have not been, but should be, settled by this Court.

The decision of the Court below raises important questions of federal law which have not been, but should be, settled by this Court to eliminate uncertainty and confusion in the application of important provisions of the federal tax statutes. The principal questions are:

> **(1) Whether the Court below correctly applied the principles laid down in the decision of this Court in *Commissioner* v. *Wodehouse*, 337 U. S. 369 (1949), which involved the transfer of a *part* of a *copyright*, to the transfer in the instant case of the *entire* ownership of a *patent*.**

The *Wodehouse* case turned upon the fact that the consideration for the transfer of a *part* of a *copyright* (serial and book rights) had been subject to withholding as a royalty at the time of the enactment of the Revenue Act of 1936. Since that Act, although it exempted nonresident aliens for the first time from tax on the sale of personal and real property in the United States, continued to impose a tax upon all income which had previously been subject to withholding, the payments to *Wodehouse* were taxable. In reaching this result, this Court relied upon the fact that the applicable Treasury Rulings required withholding, and that this position had been sustained in the only pending court case involving the question at the time the 1936 Act became effective. Both the majority and dissenting opinions assumed that the result would have been otherwise had the transaction involved been a transfer of an *entire* copyright (pp. 382 and 407). Application of the *Wodehouse* case to the transfer of an *entire* patent is therefore unwarranted.

The *Wodehouse* case is inapplicable in the instant case on the further ground that the legislative history of the provisions taxing nonresident aliens is entirely different as respects copyrights and patents. Whereas this Court found that the applicable Treasury Ruling as to the transfer of a part of a copyright required withholding at the time of the enactment of §211(a) of the Revenue Act of 1936, the precursor of the provisions applicable in that case and the instant case, the situation is otherwise as to the transfer of an entire patent. I. T. 1232, I-1 C. B. 207 (1922), involving the transfer of an entire patent in consideration of installment payments, held that withholding was *not* required.

This Court also relied on the fact that the only case involving the taxability of a part of a copyright (*Sabatini*

v. *Commissioner*, 32 BTA 705 (1935)) was on appeal at the time of the enactment of the Revenue Act of 1936, and was affirmed shortly thereafter (98 Fed. (2d) 753 (C. A. 2d Cir., 1938)), prior to the enactment of the Internal Revenue Code under which the payments involved in the *Wodehouse* case were taxable. The situation is entirely different in the case of patents. There was no case pending at the time of the enactment of the Revenue Act of 1936. The law and the Regulations were clear that the proceeds of *sales* of personal property by a nonresident alien were not subject to tax, and all cases decided prior to the decision of the instant case had consistently held that the proceeds of the transfer of an entire patent by a nonresident were not subject to tax. *General Aniline & Film Corporation* v. *Commissioner*, 139 Fed. (2d) 759 (C. A. 2d Cir., 1944); *Commissioner* v. *Celanese Corporation of America, supra;* and *Kimble Glass Co.* v. *Commissioner, supra.* The Commissioner of Internal Revenue expressed his agreement with the interpretation of the provisions relating to the taxation of nonresidents involved in these cases by publishing his acquiescence in the *Kimble* case in 1947.

The Internal Revenue Code has been amended a number of times since the decision in these cases, but Congress has indicated no disagreement with them. In the Revenue Act of 1950 the income from copyrights was made taxable to the author in all cases as ordinary income,* whereas the taxability to inventors of the income from patents was deliberately left unchanged.

At the same time the exemption of nonresident aliens from capital gain which had been in effect since 1936 was withdrawn in the case of those "temporarily present in the United States."** Had Congress not approved of the *Celanese, General Aniline* and *Kimble Glass* cases, it cer-

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* §117(a)(1)(C), added by §210(a) of the Revenue Act of 1950.
** §211(a)(1)(B), added by §213(a) of the Revenue Act of 1950.

tainly would have spoken at the same time these two closely related changes were made.

> **(2) Whether a sole and exclusive license to "make, use, exercise and vend" for the full term of a United States patent, which transfers complete ownership and control to the licensee and excludes the licensor from any rights in the patent except those incident to the collection of the stipulated consideration, is a sale for federal income tax purposes, or a mere license for the use of the patent.**

The decision below would also establish a new precedent in this regard. It draws an arbitrary and unreasonable line between such agreements providing for installment payments of a total stipulated sum and those which provide for installment payments measured by the number of patented articles sold, or by their sales price. The decision below would treat the former as a sale, and the latter as a mere license for the use of the patent.

Because of the very nature of a patent, which ordinarily involves a product or a process yet untried and therefore of uncertain value, it is frequently impossible for the inventor and the person who is to exploit it to agree upon a fixed over-all purchase price suitable to both. In such cases it is necessary to measure the consideration for the patent by the results of its exploitation.

To hold that the one transaction is a sale, but that the other is a mere license and the proceeds taxable as ordinary income, simply because it is impossible for the parties to agree upon a total stipulated sum, seems completely unwarranted. *No other court has ever reached this conclusion, and there are numerous decisions to the contrary. Commissioner* v. *Hopkinson,* 126 Fed. (2d) 406 (C. A. 2d Cir., 1942); *Commissioner* v. *Celanese Corporation of America, supra;*

Kavanagh v. *Evans, supra; Allen* v. *Werner, supra; Myers* v. *Commissioner, supra; Kimble Glass Co.* v. *Commissioner, supra; Dreymann* v. *Commissioner, supra;* and *Taylor* v. *Commissioner, supra.*

This conclusion by the Court below appears contrary, furthermore, to the opinions of this Court in the *Wodehouse* case where it was said:

> " 'While payment ordinarily is at a certain rate for each article or certain percent of the gross sale, that in itself is not determinative. The *purpose* for which the payment is made and not the *manner* thereof is the determining factor.' *Commissioner* v. *Affiliated Enterprises,* 123 F. 2d 665, 668 (C. A. 10th Cir.)." (page 394, fn. 15). (Emphasis added.)

and in *Rude* v. *Westcott,* 130 U. S. 152 (1889), where it was said:

> "* * * The concluding provision, that the net profits arising from sales, royalties, or settlements, or other source, are to be divided between the parties to the assignment so as to give the patentee one fourth thereof, *does not, in any respect, modify or limit the absolute transfer of title.* It is a provision by which the consideration for the transfer is to be paid to the grantor out of the net profits made; it reserves to him no control over the patents or their use or disposal, or any power to interfere with the management of the business growing out of their ownership." * * * (page 162). (Emphasis added.)

It appears contrary, also, to the principles laid down by this Court in *Littlefield* v. *Perry,* 88 U. S. 205 (1874), *Waterman* v. *Mackenzie,* 138 U. S. 252 (1891) and in *United States* v. *General Electric Co.,* 272 U. S. 476 (1926), where it was held, without any mention of the *manner* of payment, that an exclusive license to make, use and vend constitutes an *assignment* of a patent.

While the decision below relates to payments received by nonresidents, Judge Hand's opinion appears to require a similar result in the case of residents, and in fact the decision below has already been cited by the Court of Appeals for the Tenth Circuit in *Broderick* v. *Neale,* ..... Fed. (2d) ..... (C. A. 10th Cir., 1953)*, in support of a decision involving a resident. Added importance results from the fact that the Commissioner, although he acquiesced in the *Myers* case in 1946 and in the *Kimble Glass* case in 1947, withdrew his acquiescence in the former in 1950 and published a ruling (Mimeograph 6490, 1950–1 C. B. 9), in which he now takes the position, without citation of any authority whatever, that where the consideration for the transfer of patent rights is based upon production, sale or use, the transaction will be deemed to be a mere license despite the fact that in all other respects the transaction is a sale.** *The Commissioner is thus attempting to overrule a long line of well settled authorities and to accomplish by ruling what Congress deliberately refused to provide by statute.*

The decision below is therefore of broad application, and being contrary to many prior decisions will necessarily result in confusion and extensive litigation involving both residents and nonresidents unless the questions raised herein are promptly resolved by this Court.

Questions Presented.

(1) Did the Court below properly apply the decision of this Court in *Commissioner* v. *Wodehouse,* 337 U. S. 369 (1949), in view of the fact that:

(a) The *Wodehouse* case involved the transfer of a *part* of a copyright whereas the instant case involves the transfer of the *entire* ownership of a patent, and

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* 1952—2 U. S. T. C. Par. 9156.

** By its terms this ruling does not apply to payments received during taxable years beginning before June 1, 1950, but the Commissioner has given it retroactive effect in the instant case.

(b) The legislative history of §211(a) is entirely different as respects *copyrights* and *patents*.

(2) Is a sole and exclusive license to "make, use, exercise and vend" for the full term of a United States patent, which transfers the entire ownership and control to the licensee and excludes the licensor from any rights in the patent except those incident to the collection of the stipulated consideration, a *sale* for federal income tax purposes, or a *mere license* for the *use* of the patent?

(3) In determining whether such an agreement constitutes a sale or a mere license is it significant whether the consideration for the transfer is a stipulated total sum payable in installments, or sums measured by the number of patented articles sold or the sales price thereof?

Prayer.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued by this Court to the United States Court of Appeals for the Second Circuit to the end that this case may be reviewed and determined by this Court.

Respectfully submitted,

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FRANZ GEORG BLOCH,
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THE UNITED STATES OF AMERICA,
Defendant-Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

This brief is submitted in support of the attached petition for a writ of certiorari.

The questions presented, a summary statement of the facts, and the grounds on which jurisdiction of this Court is invoked, all appear in the petition, and for the sake of brevity are not repeated here.

Specification of Errors.

The Court of Appeals erred:

(1) In its application of the *Wodehouse* case, which involved the transfer of only *part* of a *copyright*, to the transaction involved in the instant case, which was a transfer of an *entire patent*.

(2) In holding that there had not been a sale of the patent because:

(a) The purchaser of the patent withheld from the payments in question.

(b) Of the "ease in withholding" from the payments in question.

(c) The partners retained "many substantial rights" in the patent which were "further indications of the failure to transfer absolute ownership."

(d) The payments for the patent varied according to sales of the patented product.

Statutes and Regulations Involved.

A nonresident alien not engaged in trade or business in the United States was taxed during the years here involved only upon specified types of income from sources within the United States.

"SECTION 211. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

(a) *No United States Business or Office.*—

(1) *General rule.*—

(A) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year, in lieu of the tax imposed by sections 11 and 12 upon the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States as * * * dividends, rents, salaries, wages * * * or other fixed or determinable annual or periodical gains, profits, and income, a tax of 30 per centum of such amount * * *."*

* Provisions applicable when aggregate income exceeds $15,400 are omitted (§211(a)(2)).

The Regulations defined fixed and determinable annual or periodical income to include royalties, *but expressly exclude therefrom the proceeds of sale.*

> "*Regulations 111, Section 29.143-2.* Fixed or determinable annual or periodical income.——
>
> Only fixed or determinable annual or periodical income is subject to withholding. The Internal Revenue Code specifically includes in such income, interest, dividends, rent, salaries, wages • • •. *But other kinds of income are included, as, for instance royalties.*
>
> • • • *The income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income.* • • •" [Emphasis added.]

The definition of income from sources within the United States included *royalties* for the *use* of United States patents.

> "Section 119. INCOME FROM SOURCES WITHIN UNITED STATES.
>
> (a) *Gross Income from Sources in United States.*——
>
> The following items of gross income shall be treated as income from sources within the United States:
>
> • • • • • •
>
> (4) *Rentals and Royalties.*—Rentals or royalties from property located in the United States or from any interest in such property, *including* rentals or *royalties for the use* of • • • *patents,* copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property; • • •" [Emphasis added.]

The tax was collected by withholding.

"Section 143. WITHHOLDING OF TAX AT SOURCE.

* * * * * *

(b) *Nonresident Aliens.*—All persons, in whatever capacity acting * * * having the control * * * or payment of * * * dividends, rent, salaries, wages * * * or other fixed or determinable annual or periodical gains, profits, and income * * * of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall * * * deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 30 per centum thereof. * * *"

ARGUMENT.

The *Wodehouse* Case does not Apply to the Sale of a Patent.

The Court below said that in determining whether the payments in question were taxable they must be *guided* by the *Wodehouse* case. They held that under that case the payments would be taxable if they would have been subject to withholding prior to the Revenue Act of 1936. They erroneously concluded, however, that the payments would have been subject to withholding prior to 1936, and were therefore taxable, *because they did not believe there had been a sale of the patent.*

The *Wodehouse* case provides no support whatever for the proposition that the payments in the instant case would have been subject to withholding prior to 1936. The agreement in that case involved the consideration received in 1938 and 1941 for the transfer of a *part* of the rights under a *copyright,* i.e., serial rights and book rights. A number of previous decisions had held such transfers to be merely

licenses. The only question before this Court was whether the changes in the Revenue Act of 1936, which exempted nonresident aliens from tax on the proceeds of sale of personal property and real estate in the United States, were broad enough to exempt them from tax on income from the transfer of serial and book rights—whether certain payments previously taxable by withholding had been made nontaxable by the Revenue Act of 1936.

The answer was "No". This Court held that payments which had been subject to withholding prior to 1936 continued to be taxable under subsequent Revenue Acts.* In holding the payments taxable this Court relied heavily upon the fact that the Treasury had ruled prior to 1936 that withholding was required in respect of such payments; that the only intermediate decision (*Sabatini* v. *Commissioner*, 32 BTA 705 (1935)) was in process of review when the Revenue Act of 1936 was enacted, and that it had been decided against the taxpayer (98 Fed. (2d) 753 (C. A. 2d Cir., 1938)) before the enactment of the Internal Revenue Code under which he was taxable.

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* This Court explained the reason for the change in the 1936 Act on the ground that it had been difficult for United States tax officials to ascertain the taxable income (in the nature of capital gains) which had been derived from sales of property at a profit by nonresident alien individuals or by foreign corporations when the respective taxpayers were not engaged in trade or business within the United States. This difficulty was in contrast to the ease of computing and collecting a tax from certain other kinds of income, such as interest and wages, which have no cost basis and therefore consist *wholly of income*. The opinion made it clear that the payments in the *Wodehouse* case were subject to tax because they consisted *"wholly of income * * * in contrast to gains, profits and income * * * from * * * sales of real or personal property"*. (pp. 393-394).

"Royalties" which are in fact installments of purchase price, have a cost basis and are not *"wholly income"*. If such installment payments are held subject to withholding, a nonresident alien such as petitioner will be taxed on his gross income and will not be permitted to recover his capital cost.

The *Wodehouse* decision has no application to the instant case for two reasons. In the first place, it involved a transfer of *less than all the taxpayer's bundle of rights.* Both Mr. Justice Burton, writing for the majority, and Mr. Justice Frankfurter, writing for the minority, recognized that had a sale of the entire copyright been involved, no tax would have been payable (pp. 382, 407). *In the instant case the entire bundle of rights involved in the patent was sold* (R. 121).

In the second place, the legislative history is entirely different as respects the installment sales of patents. The only ruling in point is IT-1232, I-1 C. B. 207 (1922), referred to by Judge Hand in his opinion in the *Bloch* case, and held the withholding was not required. There were no decided or pending cases on the question, but all subsequent decisions prior to the decision below held uniformly that no tax was payable. *Commissioner* v. *Celanese Corporation of America,* 140 Fed. (2d) 339 (C. A. D. C. Cir.), decided in 1944; *General Aniline & Film Corporation* v. *Commissioner,* 139 Fed. (2d) 759 (C. A. 2d Cir.), decided in 1944; *Kimble Glass Co.* v. *Commissioner,* 9 T. C. 183, decided in 1947. The Commissioner of Internal Revenue had also indicated his approval of their conclusions by publishing his acquiescence in the *Kimble Glass* case in 1947 (1947-2 C. B. 3).

If Congress felt, contrary to these decisions, that the proceeds of a sale of a patent should be taxed to a nonresident alien, it certainly would have spoken. The law has been amended a number of times since the decision in the above cases, and has been amended in two important respects since the decision in the *Wodehouse* case in 1949. For example, §117 was amended by the Revenue Act of 1950 to make income from copyrights ordinary income.* The

* §117(a)(1)(C) added by §210 of the Revenue Act of 1950.

proceeds of a sale of a part, or even all, of a copyright are now ordinary income.

When this amendment was before Congress the question of whether patents should be treated similarly was considered, but provisions in the House bill, which would have done so, were stricken out in the final version. The Report of the Senate Finance Committee states:

> "* * * Your committee believes that the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words 'invention,' 'patent,' and 'design' have been eliminated from this section of the bill." (Sen. Rep. No. 2375, 81st Cong., 2nd Sess. 44 (1950)).

This desire to encourage rather than discourage inventiveness extends also to foreigners who exploit their patents here, as has been indicated by the recent income tax treaties wherein even *true* royalties for the right to use patents derived from within the United States have been exempted from United States tax.*

Again, in the same Revenue Act, because Congress felt that certain income of nonresident aliens was improperly escaping taxation, it was provided that nonresident aliens should be taxed on any capital gains realized while they were temporarily in the United States.** If Congress had

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* Belgium, Article IX, signed October 28, 1948, ratification pending, CCH Tax Treaties Serv. par. 612; Denmark, Article VIII, 62 Stat. (2) 1730, 1733; France, Title I, Article 7, 59 Stat. 893, 898; Greece, Article VII, ratified September 17, 1951 by U. S. Senate, exchange of ratifications pending, CCH Tax Treaties Serv. par. 3110; Ireland, Article VIII (1), T. I. A. S. No. 2356, T. D. 5897, I. R. 1952-10-13817; Netherlands, Article IX, 62 Stat. (2) 1757, 1762; New Zealand, Article VII (1)(c), T. I. A. S. No. 2360, T. D. 5957, 1953-1 I. R. B. 38, 40; Norway, Article VII, T. I. A. S. No. 2357, T. D. 5956, 1953-1 I. R. B. 27, 29; Sweden, Article VI, 54 Stat. 1759, 1762; Switzerland, Article VIII, T. I. A. S. No. 2316, T. D. 4975, 1940-2 C. B. 75, 78; United Kingdom, Article VIII (1), 60 Stat. 1377, 1382.

** §211(a)(1)(B) added by §213(a) of the Revenue Act of 1950.

felt that income from the sale of patents on the installment basis should be taxed, contrary to the holdings of the *Celanese, General Aniline* and *Kimble Glass* cases, it would certainly have spoken at the time these changes were made. It has not seen fit to do so, and as Mr. Justice Frankfurter said in his opinion in the *Wodehouse* case, it is for Congress to make differentiations between the taxation of residents and nonresidents, and the courts should not assume that Congress itself evaded its own tax purposes, or that the courts must close what Congress has left open (pp. 410, 425).

The Court below did not heed Mr. Justice Frankfurter's admonition. In the *Wodehouse* case "prior practice" with respect to copyrights justified the imposition of the tax. *In the instant case there is no such prior practice, and on the contrary the only applicable Treasury Ruling and all the decided cases, except the decision below, are to the contrary.* It is submitted that there is no support in the *Wodehouse* case for the decision below. On the contrary, a proper application of the principles there laid down would have required an affirmance of the District Court's decision.

Withholding by the Licensee is Immaterial.

The Court below attempted to bring the case within the rationale of the *Wodehouse* case by holding that there had not been a sale of the patent. It based this conclusion on four grounds,* the first of which was the fact that the licensee had treated the payments as true royalties by

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* It quite properly did not allude to the fact that the agreement was cast in terms of license rather than sale. The true substance is determinative, not the nomenclature used. *Waterman* v. *Mackenzie, supra,* at p. 262; *Heryford* v. *Davis,* 102 U. S. 235, 243, 245 (1880); *Parke, Davis & Co.* v. *Commissioner, supra,* at p. 432; *Myers* v. *Commissioner, supra,* at p. 264.

withholding the tax. This argument is obviously fallacious. As was true of the licensors in *Allen* v. *Werner, supra; Myers* v. *Commissioner, supra; Hessert* v. *Commissioner,* 6 T. C. M. 1190 (1947); *Thompson* v. *Johnson* (D. C. S. D. N. Y., 1950), 50-2 U. S. T. C. Par. 9428; *Pike* v. *United States,* 101 F. Supp. 100 (D. Conn., 1951); and *Lamar* v. *Granger,* 99 F. Supp. 17 (W. D. Pa., 1951), the licensee in the instant case was mistaken as to the tax effects of the agreement. In all of these cases the taxpayers wrongly assumed that the payments in question were royalties taxable as ordinary income, and so reported them for tax purposes. They were nevertheless granted refunds when the error was discovered, even though the error was their own and not that of a third party.

Imposition of Tax not Justified by Ease of Withholding.

The second ground for holding that there had not been a sale was the ease in withholding from the payments. This argument is equally fallacious. It is no easier to withhold from periodic payments varying with sales than it is to withhold from installment payments of a fixed purchase price, which the majority of the Court below conceded were not subject to withholding. The ease in withholding referred to in this Court's opinion in the *Wodehouse* case involved payments "wholly of income" such as interest and wages. It is "easy" to withhold from such payments because no question of recovery of capital is involved. The Court below, in relying upon ease of withholding, was therefore assuming that the payments were "wholly of income", a consequence of the very conclusion they were seeking to reach.

No Substantial Rights Were Retained by Petitioner.

The Court of Appeals' third ground for holding there was not a sale was that:

> "The many substantial rights in the patent retained by plaintiff are further indications of the failure to transfer absolute ownership * * *" (R. 135).

The only provisions of the agreement referred to in its statement of facts which could have been considered "rights in the patent retained by plaintiff" are the following:

> **"Weston also agreed not to 'sell or assign in any manner whatsoever the entire license' without the partners' written consent"** (R. 132).

This is a necessary and reasonable precautionary provision. Since the proceeds of the sale of the patent depended upon the integrity, ability and financial responsibility of Weston, the partners obviously could not permit Weston to assign the entire patent to someone less able and responsible.

> **"the partners were to 'have the right of first refusal to repurchase the license for themselves'"** (R. 132).

This provision has a similar basis. The partners might well prefer to repurchase the rights transferred rather than have them fall into the hands of a less responsible assignee. Agreements of sale frequently contain a first refusal to repurchase, and these have never been held to defeat the original sale. The use of the word "repurchase" is an indication that the partners assumed they had made a sale.

> **"that should Weston default in its covenants under the contract the partners could 'terminate the license'"** (R. 132).

This also is a necessary and reasonable precautionary provision. It in no way negatives a sale. Every

well drafted sale for deferred payments contains security provisions for recovery of the property in the event of default by the purchaser. Such a provision would normally be found in an agreement providing for installment payments of a fixed over-all purchase price, which the majority concedes would be a sale.

> **"that upon Weston's notice to the partners of its decision to discontinue making the thermometers, the agreement would end"** (R. 133).

This is a common provision permitting the purchaser to abandon the agreement, in effect, if it proves worthless.

> **"that if, for three consecutive years, the total annual 'royalties' of $25,000, although paid by Weston, exceeded the earned amount under the percentage terms of the agreement, the partners could cancel the agreement"** (R. 133).

This is a normal precautionary provision. As has already been stated, the proceeds of the sale of the patent depended entirely upon its satisfactory exploitation by Weston, and if for any reason Weston were to fail to exploit it properly, the partners must necessarily have the right of repossession.

> **"In the event of any infringement being brought to the notice of the partners, they were to take necessary steps to stop such infringement, the cost of legal proceedings to be equally shared and the decision to take such proceedings to be by mutual agreement"** (R. 133).

Having retained a security title to the patent, the partners were necessary parties to any infringement action. Furthermore, in bringing any infringement action, the patent is "put on the block". If the action

is unsuccessful the monopoly of the patent is lost and royalties cease. Under the circumstances, the partners quite properly retained the right to participate in the protection of the patent, with a corresponding duty to bear a part of the cost.

> **"The partners, who were to pay all renewal fees, retained the right to exploit the patents outside of the United States"** (R. 133).

United States patents are not renewable, and so the provision as to renewal fees has nothing to do with the United States patent involved in this case. The agreement is couched in terms which follow closely the English form of exclusive license and it is probable that this provision was included inadvertently. The provision as to the rights of the partners to exploit the patented invention outside of the United States, under foreign patents, relates to completely separate and distinct properties. It does not involve a right with respect to the United States patent.

> **"Any improvements or further inventions made by Weston with respect to the patent were required to be disclosed to the partners and might be patented by them in their name"** (R. 133).

This is a customary precautionary provision to protect the partners as to improvements or further inventions in the event of repossession of the patent on account of default by Weston.

As the Court said in *Lamar* v. *Granger, supra,* "An individual of inventive mind rarely has the ability, financial or otherwise, to produce and market his invention. He has to depend upon others and it is a means of self-protection to include such clauses; otherwise he is at the mercy of the assignee." (p. 38). The courts have uniformly held that such provisions are conditions subsequent which do not prevent the contract from being one of sale.

Commissioner v. *Celanese Corporation of America, supra,* 341-342; *Allen* v. *Werner, supra,* 842; *Myers* v. *Commissioner, supra,* 264; *Kimble Glass Co.* v. *Commissioner, supra,* 190; *Dreymann* v. *Commissioner, supra,* 161; *Hessert* v. *Commissioner, supra,* 1196; *Barlow* v. *Commissioner,* 2 T. C. M. 133, 139 (1943); *Parke, Davis & Co.* v. *Commissioner, supra,* 430-432; and *Thompson* v. *Johnson, supra,* 13,129-13,130.

In the *Celanese* case, *supra,* the Court of Appeals for the District of Columbia summed up succinctly the nature and purpose of the protective provisions there involved as follows:

> "* * * In short, the various provisions to which we have referred, as well as the others referred to by the Commissioner, are provisions of a reciprocal nature in which each of the parties was seeking the most certain means of securing to the Purchaser the exclusive possession and use of the patents which it had bought and to the sellers that they should be so used as to assure as far as possible payment of the installments which were a part of the consideration of the sale." (p. 342).

Payments Varying with Sales Do Not Make a Sale a Mere License.

The Court of Appeals' fourth and principal ground for holding that there was not a sale, however, was that there was no fixed over-all purchase price. As they put it:

> "* * * But the crux of the matter seems to us to be the retention of an interest in the profitable exploitation of the patented articles by receipt of a percentage of the sales price or a stated amount for each article sold. Without such an interest there would be less need to keep the other rights retained here, particularly the right to terminate the agreement on Weston's default and recapture the patent." (R. 135).

No case has ever held before that a transfer of the complete ownership and control of a patent, which excludes the transferor from any rights except those incident to the collection of the consideration, is not a sale but a mere license because the consideration is based upon the receipts or earnings of the patent transferred. On the other hand, the many decisions cited at pages 11 and 12, *supra,* including those of this Court, are to the contrary. Furthermore, personal property of all kinds is commonly sold on the installment basis, the payments being measured by future sales, etc. Is it conceivable that the Court below would apply the principle of the *Bloch* case to such transactions? And if not, why should sales of patents be treated differently? See for example as to sales of stock, *Burnet* v. *Logan,* 283 U. S. 404 (1931), *Peck* v. *Commissioner,* 11 T. C. M. 683 (1952), *Nicholson* v. *Commissioner,* 3 T. C. 596 (1944); sale of partnership interest, *United States* v. *Yerger,* 55 F. Supp. 521 (E. D. Penn., 1944); sale of timber, *Springfield Plywood Corp.* v. *Commissioner,* 15 T. C. 697 (1950); sale of publishing rights, *TeLinde* v. *Commissioner,* 18 T. C. 91 (1952); other capital transactions, *Commissioner* v. *Carter,* 170 Fed. (2d) 911 (C. A. 2d Cir., 1948), *Westover* v. *Smith,* 173 Fed. (2d) 90 (C. A. 9th Cir., 1949).

When the hearings were being held before the Senate Committee on Finance on the 1950 Revenue Act with respect to the change in the House Bill which would have made the proceeds from the sale of patents ordinary income in all cases, Mr. C. E. Earle, secretary-treasurer of the Council for Independent Business, testified as follows:

> "It is a well-known fact that very few inventors have the money to practice their patents. In order to profit from the patent, the inventor must either sell it or license its use—usually an exclusive license which the courts have held is equivalent to a sale.

> Our patent system is responsible, to a large degree, for the tremendous and rapid growth of the industrial phase of our economy. Although the individual inventor has never been properly rewarded for his advanced thinking, vision, and personal efforts, he deserves the major part of the credit for this great progress. His type of thinking should be encouraged rather than discouraged.
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> • • • most of the important patents in this country have been created by individuals, and in many, many cases, and I would say over 98 percent of the cases, the individual himself has not had the funds to practice his own patent and has consequently been forced to either sell his patent or lease it, many, many times under unfavorable circumstances." (Hearings before the Senate Committee on Finance on H. R. 8920, 81st Cong., 2nd Session, pp. 603-604.)

To face an inventor with the choice between a tax at ordinary income rates upon the proceeds of the sale of his patent, or the negotiation of a total stipulated sum, which under the circumstances would probably be unfairly low, is indeed an unreasonable and wholly unjustified dilemma. As the Court said in *Lamar* v. *Granger, supra,* at page 38, "The parties are not required to be clairvoyant or prescient and determine beforehand a lump amount; it is a matter of speculation. The patent may be commercially marketable or it may not be and the parties account for this risk by providing for installment payments based on a percentage of sales."

In the case of foreign inventors, frequently faced with high additional taxes at their domicile, such a dilemma can not help but discourage the exploitation of inventions here. Such a policy would seem to be particularly short-sighted in these times when our very security depends upon our

acquiring the benefits of the latest technical developments by inventive genius throughout the world.

Not only is the new rule which Judge Hand lays down without authority of any kind whatever, but it is illogical and unfair in its application to patents, which in many cases are incapable of valuation. It is contrary, furthermore, to the distinction between a sale and a license laid down in the statute itself, which has been consistently recognized for many years. In the *Celanese* case, *supra,* for example, decided in 1944, the Court said in reply to the Commissioner's argument that the obligation to withhold exists in any case in which a seller of an invention still has an interest in the successful exploitation of a patent:

> "* * * But the trouble with this [argument] is that the statute itself makes the distinction and expressly declares a different rule for '*royalties* for the *use* of a patent' and for payments received in consideration of 'the *sale* of personal property' which would necessarily include the sale of a patent. (§143-(b), §119-(e), Revenue Acts of 1936 and 1938, respectively). The Treasury Regulations make this distinction clear" (p. 342). (Emphasis added.)

And in the *TeLinde* case, *supra,* decided recently by the Tax Court, which is charged with the primary responsibility for the proper interpretation of the tax laws, and whose opinions are therefore entitled to special weight in its field, it was said

> "* * * it is by now too well settled to admit of any discussion that mere payment of a consideration on the basis of sales or otherwise in a fashion commonly referred to as 'royalties' does not suffice to transmute what would otherwise be a sale into a

mere license. *Hofferbert* v. *Briggs* (C. A. 4), 178 F. (2d) 743" (p. 95).

Judge Hand's departure from this well-settled principle, unsupported by any authority whatever, cannot fail to cause much confusion, uncertainty and unnecessary litigation, and should therefore be reversed by this Court.

Conclusion.

In summary, the Court below erred in its application of the *Wodehouse* case to the sale of an entire patent. The application of that case is limited to transfers of a part of a copyright, and both the majority and minority opinions recognized that a sale of an entire copyright or patent would not be subject to tax. The Courts in numerous opinions have uniformly held that the sale of an entire patent, whether for a lump sum or for deferred installments, either percentage or fixed, is a capital transaction, and does not give rise to ordinary income, and there is no legislative history or prior practice supporting the contrary view. These decisions, furthermore, construe a regulation of long standing, which has received the unequivocal approval of Congress, for it has amended closely related sections of the Internal Revenue Code on numerous occasions, in one instance even differentiating between the taxation of sales of copyrights and patents.

The fact that the licensee withheld tax is of no significance. It is not easier to withhold from percentage payments than from deferred lump sum payments, which it concedes are not subject to tax. Neither petitioner nor the partners retained any substantial rights negating a sale of the patent. They retained only a normal security interest, and the unspecified rights which the Court

below thought the partners had retained were mere precautionary security provisions—mere conditions subsequent—which uniformly have been held to be consistent entirely with a sale.

Finally, the fact that the sales price was determined by receipts from articles manufactured under the patent does not carry the significance which the Court below has attributed to it. Sales based upon a percentage or share of receipts are commonplace, not only in the case of sales of patents but in sales of many other types of personal property and real estate.

The Court below concedes that its opinion is at variance with decisions of the Courts of Appeals for the Fifth and District of Columbia Circuits and the Tax Court, and the question involved is one of considerable public importance.

WHEREFORE, your Petitioner respectfully prays that his petition for a writ of certiorari be granted.

Respectfully submitted,

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